BEFORE THE PUBLIC UTILITIES COMMISSION OF THE

STATE OF CALIFORNIA

Application of Pacific Gas and Electric Company for Approval of 2013-2014 Energy Efficiency Programs and Budget (U39M).	Application 12-07-001
And Related Matters.	Application 12-07-002 Application 12-07-003 Application 12-07-004

SOUTHERN CALIFORNIA EDISON COMPANY'S (U 338-E) MOTION FOR CLARIFICATION PURSUANT TO ORDERING PARAGRAPH #49 OF D.12-11-015

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I.

INTRODUCTION & BACKGROUND

Pursuant to Rule 11.1 of the Rules of Practice and Procedure of the California Public Utilities Commission (Commission or CPUC), and Ordering Paragraph (OP) 49 of Decision (D.) 12-11-015,[1] Southern California Edison Company (SCE) respectfully submits this Motion for Clarification (Motion). SCE seeks clarification regarding how costs associated with energy efficiency fixed price contracts (also known and referenced herein as performance-based or pay-for-performance contracts) are to be reported for accounting purposes.

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[1] D.12-11-015 OP #49 states, "The assigned Commissioner and assigned Administrative Law Judge are authorized to take all procedural steps, including modifications to the schedule set forth herein, to promote the objectives in this decision and to provide clarification and direction as required to assure the effective, fair and efficient implementation of this decision in this proceeding or in the Energy Efficiency Rulemaking 09-11-014 or its successor."

SCE has pursued energy efficiency fixed price contracts since approximately 2009 because they are low-risk to ratepayers and very cost competitive. Consistent with the Commission's Energy Efficiency Policy Manual,[2] third-party vendors classify all costs billed to the IOUs as either administrative, marketing, or direct implementation. While traditional time and material contracts allow vendors to allocate costs into these three categories when they are incurred, fixed price contract costs are reported using a pre-determined "cost allocation" method (e.g., set percentages such as 9% administration, 5% marketing, etc.) based on estimated budgets. This method provides reasonable informational data for reasons described herein. The Commission has both supported fixed price contracts, and required that costs be tracked by the three categories, since at least 2010.

On May 18, 2012, the Commission issued a Decision re-affirming the use of fixed price contracts "going forward."[3] After the issuance of that Decision, and the approval of SCE's 2013-2014 program portfolio,[4] the Commission's Utility Audit, Finance and Compliance Branch (UAFCB) conducted an audit of SCE's energy efficiency financial compliance for the period January 1 through December 31, 2011. UAFCB raised concerns regarding whether the cost allocation method used for fixed price contracts complied with the Commission's cost reporting requirements. UAFCB recommended that Energy Division work with the IOUs to decide whether the utilities' practices were appropriate. If deemed appropriate, UAFCB then recommended that the Commission require the IOUs audit 20 percent of the costs charged by its contractors annually to verify that the cost allocations reflect actual costs.[5]

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[2] Energy Efficiency Policy Manual, Applicable to post-2012 Energy Efficiency Programs, Version 5, July 2013; and Energy Efficiency Policy Manual, Applicable to post-2005 Energy Efficiency Programs, Version 4, August 2008.

[3] D.12-05-015, p. 154.

[4] D.12-11-015.

[5] Utility Audit, Finance, and Compliance Branch (UAFCB), Energy Efficiency Financial Compliance Examination Report of Southern California Edison (SCE) for the Period January through December 31, 2011, dated September 27, 2013, p. A-16 – A-17.

UAFCB's concerns with SCE's fixed price contract cost allocation practices were not identified until 2013 when UAFCB audited 2011 expenditures. UAFCB's concerns appear to conflict with direction SCE has previously received from the Commission; that is, the UAFCB seems to have concerns with the fundamental approach of fixed price contracts, which do not require precise tracking of time and material.

SCE's purpose in filing this Motion is to receive clarification on cost allocation practices for energy efficiency fixed price contracts, which will, in turn, resolve numerous pending issues, including:

- The $24.5 million in direct implementation contracting costs that were considered a "potential reporting discrepancy" by UAFCB,[6] based solely on concerns regarding cost allocation for fixed price contracts;
- A portion of SCE's 2011 energy efficiency incentive award related to contracting expenditures being withheld "until additional information is obtained regarding these reporting practices;"[7]
- The pending UAFCB audit of SCE's 2012 energy efficiency portfolio costs and future 2013 and 2014 audits which are likely to raise the same concerns and issues; and
- The energy efficiency incentive awards for 2012, 2013, and 2014 are at risk for disruption.

Per UAFCB's recommendation, SCE and Energy Division have been engaged in discussions on this matter. The information and mutual understandings developed as a result of these discussions may inform the Administrative Law Judge (ALJ) and the Commission on this issue.

II.

DISCUSSION

Fixed price contracts are utility agreements with third-parties for the implementation of energy efficiency measures at a set "flat" price per installation of each measure. Third-party implementers

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6 *Id.*, p. A-15.

7 Resolution E-4633, p. 14.

bundle their costs and bid one total price that, if accepted by SCE, becomes the "fixed" price that SCE will pay for the performance of the contract.

A. <u>In 2006, the Commission Directed the Utilities to Track Energy Efficiency Costs by Administration, Marketing, and Direct Implementation</u>

In 2006, the Commission updated the energy efficiency reporting requirements to track post-2005 energy efficiency activity costs by three categories: ***administration***, ***marketing***, and ***direct implementation***.[8] This allows the Commission and key stakeholders greater insight into how money is spent and the performance of the IOUs' portfolios.[9] At that time, third-party contracts were predominantly time and material contracts, which, by their nature, easily allowed for reporting and verification by the three categories.

The Commission also stated its expectation that the content and format of these reporting requirements "will need to be modified over time,"[10] as key stakeholders assess their information needs as well as the progress of IOU portfolio plans. "Therefore, the reporting requirements adopted at this juncture should be viewed as the 'first generation' of reporting requirements for post-2005 energy efficiency activities, and not the final word."[11] The Commission expected rules would need to be flexible and may need to change over time. Now that third party contracts have become predominately fixed price contracts, revisiting these rules is prudent.

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8 R.01-08-028, Administrative Law Judge's Ruling on Reporting Requirements, dated February 21, 2006, p. 10 [emphasis added].

9 *Id.*

10 *Id.* at p. 3.

11 *Id.* at pp. 3-4.

B. In 2012, the Commission Re-affirmed the Benefits of Fixed Price Contracts and Directed Utilities to Increase Their Use

The Commission re-affirmed its support for fixed price (performance based) contracts in D.12-05-015, stating:

> "We agree with the majority of parties that IOUs should expand their commitment to third-party implementation. We find two principle reasons to rely more heavily on third-party program implementation. First, to a large extent, third-party implementation can occur pursuant to 'performance based' contracts. Under such agreements, executed between the IOU and the third-party, the third-party implementer *accepts* the risk for program non-performance: if verified energy savings do not result from the program, the third-party service provider receives reduced compensation. With effective IOU oversight, performance based contracts can effectively mitigate risk that ratepayer contributions do not produce commensurate value. While we recognize that all of California's objectives for energy efficiency cannot be achieved through performance based contracts alone, we conclude that their use should be increased by the IOUs going forward."[12]

The Commission directed the IOUs to increase their use of performance-based contracts going forward, recognizing fixed price contracts eliminate ratepayer risk of non-performance.

C. To Comply With Both Commission Directives, Third Parties Use A "Cost Allocation" Method for Reporting Fixed Price Contract Costs

Most of SCE's third-party contracts are now fixed price contracts, which, by their nature, do not require precise tracking of time and material. Instead, SCE and the third party focus on performance: namely that the third party completed the scope of work required for the price agreed upon in the contract. Administration, marketing, and direct implementation costs are aggregated in the contract's fixed price (which is in either a "cents-per-kWh saved" format or a "fixed-price-per-energy efficiency measure-installed" format). This simple "fixed price" approach is what makes these contracts economical and competitive, while reducing risk to ratepayers.

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12 D.12-05-015, p. 154.

However, SCE does have some oversight over administration, marketing, and direct implementation expenditures in fixed price contracts, and this information is used to meet the Commission's cost reporting requirements. When a third party bids into a project, they provide SCE with a detailed estimated budget broken out by the Commission's three cost categories, in addition to financial information, including actual labor rates. SCE reviews the budget and remaining financial information to evaluate whether the price and the budget breakdown are just and reasonable. The third party then uses their estimated budget allocations (for instance, they may estimate 9% administration, 5% marketing, etc.) for reporting. Although this approach does not allow all components of the cost allocations to be verified to source data, it is not arbitrary and does provide SCE and the Commission significant (and reasonably accurate) visibility into cost breakdowns. In addition, if there are significant changes to the scope of work or the third party's business cost structure, budgets and cost allocations are reviewed and updated.

Because of the difficulty and cost associated with tracking precise costs in a fixed price contract, the method described above is the most efficient and economical way to take advantage of fixed price contracts while maintaining transparency and oversight over how much money is being spent on administration, marketing, and direct implementation activities. Tracking more precise cost allocations would incur significant marginal costs for a small amount of incremental benefit.

This cost allocation approach is consistent with what SCE understands to be the practice at other IOUs and, importantly, no other IOU received audit findings related to fixed price contracts in their 2011 audits.

D. In 2013, UAFCB Provided Its First Indication that Using a Cost Allocation Method for Fixed Price Contracts Could Be a Potential "Reporting Discrepancy"

The UAFCB Energy Efficiency Financial Compliance Examination Report of SCE for the Period January through December 31, 2011 (Audit Report), dated September 27, 2013, contained the following recommendation regarding fixed price contracts:

> "***Recommendation 9 (a):*** *The Energy Division should meet with the utilities to discuss their contracting practices and how these costs are provided. If Energy Division and/or the Commission decide that the utilities' fixed price contracting with allocations is appropriate, the Commission should require the utilities to verify 20% of the costs charged by its contractors annually to ascertain if the fixed allocation percentage amounts are correct. The utilities should require contractors to bill for actual work performed in the three categories and not by a preset arbitrary percentage. (b) SCE needs to maintain adequate supporting documentation."*[13]

The UAFCB concludes that the fixed price cost allocation method is "arbitrary," and states that costs allocated in this manner are only estimates and may not reflect the true allocation of actual costs, resulting in potential misclassification of certain costs. UAFCB also states that in future examinations costs that are not properly supported with source data may be disallowed.

E. Fixed Price Contracts Are a Valuable Energy Efficiency Resource and the Commission Should Either Exempt Them from the Portfolio Monitoring Reporting Requirements, or Provide Clear Approval to Continue Current Cost Allocation Practices

UAFCB's recommendation that fixed price contracts should track actual administration, marketing, and direct implementation costs, rather than an informed cost allocation approach, would negate the efficiency and simplicity of fixed price contracts. Aside from being overly burdensome and unnecessarily increasing compliance and administration costs for the programs, this would put the utilities back in the position of reviewing and making determinations on the actual time and materials costs related to the project. This defeats the purpose of the "flat fee" nature of these arrangements and, depending upon the terms of the contract, the utilities may not even have access to some direct third-party cost information.

Similarly, UAFCB's recommendation that the IOUs "verify 20% of the costs charged by its contractors annually to ascertain if the fixed allocation percentages are correct"[14] would negate many

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[13] UAFCB, Energy Efficiency Financial Compliance Examination Report of SCE for the Period January through December 31, 2011, dated September 27, 2013, p. 3.

[14] It is unclear whether UAFCB's recommendation is for IOUs to audit 20% of all contracts, 20% of select contract types (e.g., fixed price and/or hybrid), or 20% of total select contract costs (in which case this

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fixed price contracts benefits. For the 2010-2012 cycle, SCE had a total of 71 applicable contracts.[15] Auditing these contracts would likely be very costly, or in some cases not possible. If the audit scope included verification of compliance with the allowable cost reporting requirements, the audit costs would be significantly higher due to the added complexity, such as accessibility of financial records and proficiency in evaluating technical energy efficiency program data combined with appropriate cost accounting practices. SCE may not have the right to sufficiently audit all of the administration, marketing, and direct implementation costs associated with these contracts. Moreover, SCE may not be privy to certain costs due to non-disclosure agreements third parties may have signed with other customers.[16]

Therefore, SCE seeks clarification from the Commission that either: (1) energy efficiency fixed price contracts are exempt from requirements to track costs as administrative, marketing, and direct implementation; or (2) the "cost allocation" method described in Section C is an acceptable practice for complying with the Commission's cost reporting requirements. If this matter does not get resolved, SCE will re-evaluate fixed price contracts in light of the risk associated with their continued use.

Consistent with Finding 9(a) of the UAFCB Audit Report that Energy Division work with the IOUs to determine whether the utilities' contracting practices were appropriate, SCE and Energy Division have entered into discussions to gain a common understanding of the issues at hand and come to a resolution. These discussions have been helpful to date and may yield information that allows the Commission to properly clarify this issue. SCE submits this Motion due to the significance of the issue and the number of other pressing concerns reliant on its resolution.

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theoretically could be one contract). Based on the UAFCB's desire to ascertain if allocation methods are correct, SCE assumes the Commission is recommending the former, meaning all 71 contracts would need to be audited.

[15] This included 55 fixed price contracts and 16 hybrid contracts. The rest of SCE's 2010-2012 program cycle contracts were six time and material contracts. Hybrid contracts include both fixed unit price and time and material components.

[16] For example, if a third party's payroll clerk processes payroll for every employee, SCE may not be privy to all the data needed to verify the costs reported for processing payroll related to SCE's program.

III.

CONCLUSION

For the reasons stated above, SCE respectfully requests the Assigned Commissioner and/or the Assigned ALJ issue a Ruling clarifying that energy efficiency fixed price (also known as performance-based or pay-for-performance) contracts are not required to track costs as either administrative, marketing, or direct implementation. In the alternative, SCE requests a Ruling clarifying that the "cost allocation" method as defined in Section C is an acceptable practice for complying with the intention of the Commission's cost reporting requirements.

Respectfully submitted,

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